

OFFICE INDEX

Q2 2020 OFFICE ASSESSMENT – OBSERVING THE PANDEMIC’S EFFECTS

Across the county many of the nation’s office buildings sit largely vacant as the Covid-19 pandemic stretched in the second quarter and continued to cloud future demand for office space. The 1,575 office properties in the NCREIF Property Index realized a -0.50% total return in Q2 2020; the office sector last posted negative total returns in the aftermath of the GFC in Q4 2009. Write-downs contributed to the negative total returns in the second quarter. Appreciation returns dropped 177 bps to -1.58%, the negative turn weighing on total returns despite relatively stable income returns in the quarter. In the initial onset of the pandemic in Q1 2020, appreciation returns had slowed to 0.19%. The income return remained steadfast, and dropped just one basis point from 1.09% in Q1 2020 to 1.08% in Q2 2020. Longer term, COVID-induced disruption could lead to further repricing in the sector.

The COVID crisis has shown us that working remotely is possible for many business functions with today’s technology; quotes from executives that question their firms’ future need for office space abound. Academic research suggests that some tasks done in offices are easily accomplished, perhaps with even more productivity; conversely, team-based work often shows a decline in productivity in remote work environments. Additionally, remote work, or at least the opportunity for a flexible workweek with some time spent in the office, is emerging as a majority preference for office workers per pandemic-era surveys. The longer the pandemic continues, the greater the degree to which remote work will gain more widespread acceptance, and technological tools to enable remote working will also continue to grow in response. Cushman and Wakefield’s CEO Brett White recently estimated that 10% of the workforce could remain at home permanently, which limits growth prospects for the office sector over the medium-term.

For health and safety purposes, it is necessary that employees are more spaced out within indoor office environments, and this has sometimes been mandated by local officials. This represents an abrupt change from the previous decade, which was characterized by the transition to the “open office” floorplan and ever-denser office environments. In the medium-term, assuming the development of effective vaccines and treatments for COVID-19, fears of the pandemic may wane and densification may resume. Nonetheless, reverse densification could somewhat counteract downsizing related to WFH in the near-term.

In this period of heightened uncertainty, brokers report that renewals far outpace new lease commitments, and Q2 2020 renewals skew short-term relative to history. Some recent anecdotes suggest an end to the prevailing trend of heavy lease inducements in favor of lower-rent, lower-capex agreements. This may end up being a positive for landlords as net effective rents can be higher under these programs. Shorter lease terms with decreased capex make office cash flows much more like the rented residential sector but demand more active management, which may be operated in the future by third-party flexible space operators.

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OFFICE TOTAL RETURNS

	Total NPI	Total Office	East	Midwest	South	West
2nd Q 2020	-0.99	-0.50	-0.55	-1.23	-0.96	-0.17
1st Q 2020	0.71	1.28	0.91	0.42	1.36	1.81
One Year	2.69	3.97	2.23	1.48	3.96	6.44
Three Years	5.44	5.76	3.94	3.92	6.51	7.98
Five Years	6.77	6.42	4.84	4.90	6.36	8.61
Ten Years	9.70	9.05	7.95	6.59	8.74	10.97
Twenty Years	8.42	7.72	8.02	5.39	7.02	8.42

OFFICE INCOME RETURNS

	Total NPI	Total Office	East	Midwest	South	West
2nd Q 2020	1.01	1.08	1.02	1.04	1.23	1.11
1st Q 2020	1.10	1.09	1.01	1.03	1.23	1.15
One Year	4.40	4.40	4.11	4.47	4.99	4.52
Three Years	4.52	4.50	4.15	4.91	5.31	4.57
Five Years	4.63	4.52	4.17	5.16	5.43	4.55
Ten Years	5.19	5.07	4.76	5.82	5.80	5.06
Twenty Years	6.09	6.10	5.94	6.71	6.62	5.98

OFFICE APPRECIATION RETURNS

	Total NPI	Total Office	East	Midwest	South	West
2nd Q 2020	-2.00	-1.58	-1.57	-2.27	-2.19	-1.28
1st Q 2020	-0.39	0.19	-0.10	-0.61	0.13	0.66
One Year	-1.65	-0.41	-1.82	-2.89	-1.00	1.86
Three Years	0.89	1.22	-0.20	-0.96	1.16	3.30
Five Years	2.07	1.84	0.65	-0.25	0.90	3.93
Ten Years	4.35	3.84	3.08	0.74	2.82	5.70
Twenty Years	2.22	1.54	1.99	-1.26	0.38	2.33

OFFICE INDEX—QUARTILE RANGE OF RETURNS

